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No. 79-509

In the Supreme Court of the United States

OCTOBER TERM, 1979

EXXON CORPORATION,

Appellant,

vs.

WISCONSIN DEPARTMENT OF REVENUE,

Appellee.

On Appeal From the Supreme Court of Wisconsin

BRIEF OF APPELLANT

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BRIEF OF APPELLANT

OPINIONS BELOW

The opinion of the Supreme Court of Wisconsin is reported at 90 Wis.2d 700, 281 N.W.2d 94 (1979); the opinion of the Dane County Circuit Court is reported at CCH Wis. Tax Reports, par. 201-373; and the Decision and Order, Findings of Fact and Conclusions of Law of the Wisconsin Tax Appeals Commission is reported at CCH Wis. Tax Reports, par. 201-223. Copies of the foregoing are set forth, respectively, in Appendices A, B and C at JS App. 1, App. 36 and App. 66 to Appellant's Jurisdictional Statement (herein referred to as "JS App.").

JURISDICTION

Jurisdiction of this Court is invoked pursuant to 28 U.S.C. §1257(2), this being an appeal which questions the validity of Wis. Stats. §§71.07(1) and (2) on the ground that they are repugnant to the Constitution of the United States, the validity of which was upheld by the Supreme Court of Wisconsin.

The opinion of the Supreme Court of Wisconsin was filed on June 29, 1979. A remittitur order was entered on August 7, 1979. No rehearing was had or requested. The Notice of Appeal was filed with the Supreme Court of Wisconsin on September 21, 1979.

The Jurisdictional Statement was docketed with this Court on September 26, 1979, and this Court noted probable jurisdiction on November 26, 1979.

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

Commerce Clause (Art. I, §8, cl. 3):

> "The Congress shall have power . . . to regulate commerce with foreign Nations and among the several States, and with the Indian Tribes;"

Due Process Clause (Amend. XIV, §1):

> "[N]or shall any State deprive any person of life, liberty, or property, without due process of law;"

The pertinent parts of Wis. Stats. §§71.07(1) and (2) are set forth in Appendices F and G, JS App. 80.

QUESTIONS PRESENTED

1. Whether the State of Wisconsin's assertion that Appellant's total corporate operations constitute a single unitary business for purposes of state taxation, coupled with some alleged nexus between Appellant's operations within the State and some phase of Appellant's total corporate activities, thereby subjecting virtually all of Appellant's corporate income to apportionment, has rendered Wis. Stats. §71.07(2) invalid under the Due Process Clause of the Fourteenth Amendment to the United States Constitution.

2. Whether the State of Wisconsin's assessment of income tax on Appellant's Exploration and Production functional income derived outside the State from extraction of oil and gas not sold to third parties at the well head, and thereby refusing to allocate such income to situs, constitutes a construction of Wis. Stats. §§71.07(1) and (2) which renders the statute invalid under the Due Process Clause of the Fourteenth Amendment to the United States Constitution.

3. Whether the State of Wisconsin's assessment of income tax on Appellant's Exploration and Production functional income derived outside the State from extraction of oil and gas not sold to third parties at the well head, and thereby refusing to allocate such income to situs, constitutes a construction of Wis. Stats. §§71.07(1) and (2) which renders the statute invalid under the Commerce Clause of the United States Constitution.

STATEMENT OF THE CASE

A. Corporate Organizational History.

Exxon Corporation ("Exxon") was formerly named Standard Oil Company (New Jersey), which prior to the name change in late 1972 was the parent of a wholly owned subsidiary corporation named Humble Oil & Refining Company ("Humble"). At about the time of the name change Humble was merged into Exxon, making Exxon the legal successor to Humble, the original taxpayer in this action.

B. Reporting and Audit Pattern.

Appellant timely filed its Wisconsin corporate income and franchise tax returns for the calendar tax years of 1965 through 1968. These returns were prepared and the computations made on the separate state accounting method. Losses were sustained in all four of these calendar years, and no tax was shown as being due for any of these years. (Exhibits 11-7A, 7B, 7C and 7D; A. 636-719). On adverse examination the auditor for the Wisconsin Department of Revenue (the "Department") admitted he could not really challenge the separate accounting results. (A. 627-635).

The field audit for the years in issue concluded that Appellant "is an integrated oil company" and that since Appellant "is a unitary company and its Wisconsin business is an integral part thereof, formula apportionment of the company's income is mandatory and separate accounting is not permissible." As a result it was found that Appellant was "subject to tax on or measured by additional income of $4,532,155" for the period of 1965 through 1968. Additional taxes in the amount of $316,470.85 were thereby assessed. (Exhibit 15, A. 744-750).

The Department in its audit subjected Appellant's income to formula apportionment under the Wisconsin statutes, and in the case of crude oil production the Department devised and applied what was termed the "barrel formula" as a means (at least according to the Department's theory) of separating two sets of income figures:

(a) That derived from the well head sale to third parties of crude oil produced by Appellant; and

(b) That derived from crude oil produced by Appellant and transferred to its refineries.

The former was allocated to situs and the latter was left in the apportionment formula. (A. 73-74). This separation attempted by the Department was an impossible one, for Appellant both bought and sold crude oil, and the crude oil that went to Appellant's refineries, due to commingling, had completely lost its identity as between Appellant's produced crude and its purchased crude. (A. 299-300).

C. History Before Lower Courts.

To contest this assessment Appellant filed its Petition for Review (see Appendix H, JS App. 81) with the Wisconsin Tax Appeals Commission ("Commission"). The Commission, after extensive hearings, rendered its Decision and Order on April 8, 1976 (see Appendix C, JS App. 66), holding in pertinent part that:

1. Appellant's three main functional operations, Exploration and Production, Refining and Marketing, were each separate unitary businesses;

2. The apportionment formula used by the Department in the audit and assessment was improper in including income from Appellant's Exploration and Production and Refining functions, and resulted in a tax on extraterritorial income earned by Appellant;

3. An apportionment formula, apportioning income earned by Appellant from its Marketing function within and without the State of Wisconsin, would be proper within the mandate of Section 71.07(2); and

4. Under the Department's assessment the income of Appellant's Exploration and Production and its Refining functions was subjected to multiple taxation.

The Commission's decision was appealed by the Department to the Circuit Court for Dane County, Wisconsin. That court rendered a Memorandum Decision (see Appendix B, JS App. 36) finding that Appellant's total corporate business constituted a single unitary business and that its total corporate income was subject to apportionment. However, the Circuit Court also found that all of Appellant's income from its Exploration and Production function was situs income and could not be included in apportionable income by the Department, without regard to whether the extracted crude oil and gas was sold to third parties at the well head or transferred to Appellant's refineries. In addition, the Court found that the taxation of income from Appellant's crude oil and gas produced and not sold to third parties resulted in multiple taxation of such income.

The Circuit Court's decision was brought before the Wisconsin Supreme Court on cross appeals, with Appellant appealing the decision regarding the unitary business holding and the Department appealing the situs income question.

The Wisconsin Supreme Court reversed the Circuit Court's decision on the situs income issue and affirmed on the single, corporate unitary business issue (see Appendix A, JS App. 1).

D. Appellant's Corporate Structure and Corporate Operational Pattern.

Appellant's corporate organization structure during the years at issue consisted of three parts, Corporate Management, Coordination and Services Management, and Operations Management. Corporate Management was composed of a board of directors, an executive committee, a chairman of the board who was also the chief executive officer, a president and various directors-in-charge who were members of the board of directors. (Exhibit 20, A. 755; A. 187). Coordination and Services Management consisted of corporate staff departments with the responsibility of providing the overall specialized corporate services that were needed by the corporation. (A. 188-189).

Operations Management was responsible for directing the operating activities of the individual functional segments of Appellant which consisted of Exploration and Production, Refining, Marketing, Marine, Coal and Shale Oil, Minerals, and Land Management. Each functional segment was organized into a separate department which operated independently of each other operating segment, and was organized in a way so that it could perform essentially on a stand-alone basis. Each operating department was responsible for its own performance both operationally and financially. (A. 193-194).

The Exploration and Production functional department was actually composed of three segments, Exploration, Production and Natural Gas. Exploration had the responsibility for the acquisition of reserves of crude oil and gas. Production was responsible for the operation of all of Appellant's producing oil and gas properties including the operation of the natural gas plants and related facilities. Natural Gas was responsible for the purchase and

sale and distribution of natural gas. These three segments were considered part of the Exploration and Production function by the company for accounting purposes. (A. 194-196).

The Refining Department was responsible for the operation of Appellant's refineries and associated facilities which manufactured petroleum products, special products and petrochemical feed stocks. The Marketing Department was responsible for the distribution and sale of petroleum products through Appellant's marketing facilities. (A. 196).

Each of the functional operating departments had its own separate management responsible for the proper conduct of department operations. (A. 203-204). Each functional department was a separate investment center, and records were maintained for each of these departments to reflect the investments in properties and fixed plant. Each operating department had its own accounting office which recorded and reported the cost analysis and the financial results of its operations. (A. 204-206).

Appellant did not have any crude oil or natural gas production in the State of Wisconsin, nor did it have any refineries located in the State of Wisconsin. Only Appellant's Marketing Department operated in Wisconsin. (Exhibit 21, A. 756; A. 214 and 221).

The State of Wisconsin was an expansion marketing area where Appellant was making an entry into a new market. Appellant was not widely known in Wisconsin, had limited facilities in the State and, therefore, was required to make additional investments over a long period of time in order to achieve the market position that would make Wisconsin acceptable as a mature market. During the 1960's, results of the marketing operations in Wisconsin were very unsatisfactory and resulted only in losses. (A. 216-218).

E. Utilization of Third-Party Transfer Prices.

It was the policy of Appellant that the transfer prices or values for products and raw materials passing between its three major functional departments, *i.e.,* Exploration and Production, Refining and Marketing, should be based upon competitive wholesale market prices. As there was no mandatory requirement for crude oil produced by Appellant to flow through its own refineries, and no requirement that its refined products flowing into Marketing be produced from Appellant's own crude oil production, such crude was either sold to third parties or transferred to one of Appellant's refineries depending upon which method would be the most economical. These refineries were not interested in the ownership of the crude or in the source from which it was produced, but, rather, were concerned only with the quality and type of crude oil that was available. (A. 204-206, 299). Appellant produced crude oil was always transferred from Production to its Supply Department (a non-profit center for the purchase, sale and distribution of crude oil) and then on to the Refining Department or sold to the third parties on the basis of the posted field price for the field in which the crude was produced plus the applicable tariff for transportation. (A. 206-207 and 299-300).

A posted field price was a published price which indicated what a company was willing to pay for the crude oil it might buy from a particular field. It applied to all purchases of that particular crude, but it was not a commitment to buy; nonetheless it was a publication of the price at which crude oil would be purchased if it was in fact purchased. Supply determined what Appellant had to pay in order to buy the crude oil it needed. The posted field prices were printed on bulletins by the company which was purchasing the crude oil, and it was a bona fide competitive price. All dispositions of crude oil by Appellant

were made at the posted field price, whether the distribution was a transfer to Appellant's refineries by the Supply Department or a sale to third parties by Supply. (A. 301-304; Exhibit 11-11, pp. 1-2, A. 720-721).

The posted field price was the price utilized by Appellant to pay royalty owners under the leases that permitted Appellant to produce the oil. This price was also used by Appellant to pay for oil purchased from any parties having working interests in any particular wells or leases. Whenever Appellant sold crude oil to third parties the posted field price was used as the sales price. Supply, in turn, when it transferred crude to the Refining Department, transferred it at the posted field price. (A. 304-306). The posted field price was also utilized for purposes of computing depletion for federal income tax purposes, and for computing the severance tax due to producing states. This price was likewise used by producing states to determine the income allocable to the well head for state income or franchise tax purposes. (A. 393 and 431-432).

None of Appellant's natural gas went to the Refining Department for product conversion. The only gas that went to the Refining Department was used for fuel consumption and amounted to approximately four percent of Appellant's natural gas. All of the gas sold by Appellant was sold in the states where it was produced. The Natural Gas segment did not have any activities in the State of Wisconsin. (A. 328-330). All gas sold by Appellant to third parties was sold at a contract price negotiated with the purchaser. All gas purchased by Appellant was also purchased pursuant to negotiated contracts. Any internal transfer of gas by Appellant was based upon third-party contracts in effect at the time of the transfer. (A. 330-332).

Products transferred from Appellant's Refining Department to its Marketing Department were transferred on the basis of wholesale market prices or some equivalent value

usually based on prices quoted in Platt's Oilgram. Platt's Oilgram was a price service that primarily reported the wholesale market prices of various petroleum products at various points in the United States. These were prices of transactions between unrelated buyers and sellers and were prices at which products were actually changing hands in the trade. During the years 1965 through 1968 products transferred between the Refining Department and the Marketing Department were based on a formula tied to the price in Platt's Oilgram with a discount based upon a large third-party sales contract with Standard Oil of Kentucky. (A. 206-207 and 340-343). If for any day there was a change in the Platt's price for a product there would be a corresponding change in the transfer price between the Refining Department and the Marketing Department. (A. 346). All other products were also transferred at prices equivalent to third party arm's length prices. (A. 206-207).

The basic objective of Appellant's transfer pricing system was to provide a basis for valuing transfers which would approximate the same results as if one separate independent company had negotiated with another separate independent company. (A. 207).

F. Accounting Practices In The Petroleum Industry And The Use Thereof By Appellant.

As noted above, in the oil industry the posted field price was a figure at which crude oil was bought and sold in the market place. For accounting purposes that price was used as the measure of the sales value for crude oil. Multifunctional oil companies used posted field prices as a measure of value in transferring crude oil from their exploration and production functions to their refining departments. Without exception, the oil companies used posted field prices in this manner. These companies also used

transfer prices on natural gas which were related to existing third-party contracts. (A. 430).

For accounting purposes, to correctly and fairly determine the income of the exploration and production function, the use of posted field prices on transfers between exploration and production and refining gave a result equivalent to a third-party sale price. For transfers between refining functions and marketing functions of multifunctional oil companies, Platt's Oilgram was principally used to determine the transfer prices. Such a use provided an accounting result equivalent to a third-party sale price which was arm's length and fair and reasonable for accounting purposes. For internal accounting purposes, the functional operating departments of a multifunctional oil company were generally treated as separate functional segments. (A. 435-438).

Therefore, through the use of arms' length industry price indicators, Appellant's internal accounting and transfer pricing procedures isolated and supported the identification of: (1) income derived at the situs of production for the Exploration and Production Department; (2) income derived at the point of operation for the Refining Department; and (3) income derived at the point of operation for the Marketing Department. (A. 447-448).

From an accounting standpoint, there was no relationship between the income of the Exploration and Production Department and business done by Appellant in the State of Wisconsin. Under generally accepted principles of accounting, such income was fully earned or derived by the Exploration and Production Department at the point where the oil and gas was available for disposition. Under generally accepted principles of accounting, the Refining and Marketing Departments did not serve either to increase or to decrease the amount of Appellant's Exploration and Production functional income. (A. 389-390, 442 and 448-449).

SUMMARY OF ARGUMENT

1. The Wisconsin Supreme Court made a determination that because Appellant engaged in multiple functional operations on a multistate basis within a single corporate entity it was unitary *per se* and, hence, subject to having virtually its total corporate income included in the Wisconsin apportionment formula even though it merely engaged in a single function, very limited marketing activities, within the State of Wisconsin. Such a unitary *per se* concept was rejected in *Hans Rees' Sons* v. *North Carolina*, 283 U.S. 123 (1931), where this Court stated:

> ". . . [T]he fact that the corporate enterprise is a unitary one, . . . does not mean that for the purpose of taxation the activities which are conducted in different jurisdictions are to be regarded as 'component parts of a single unit' so that the entire net income may be taxed in one state regardless of the extent to which it may be derived from the conduct of the enterprise in another state." (283 U.S. at 133).

The *Hans Rees'* decision was in no way changed by the decision in *Butler Brothers* v. *McColgan*, 315 U.S. 501 (1942), for in *Butler Brothers* this Court simply indicated that the taxpayer had failed to carry the burden of showing by clear and cogent evidence that the formula of apportionment had resulted in the taxation of extraterritorial values.

This Court's most recent decision in the field of state income taxation was *Moorman Manufacturing Co.* v. *Bair*, 437 U.S. 267 (1978), wherein this Court acknowledged that separate functional accounting may be used by a taxpayer to identify the income or profits from various phases or functions of a taxpayer's operations, and thereby establish that the income attributable to a given state

is "out of all appropriate proportion to the business transacted . . . in that state." (*Hans Rees' Sons, supra,* 283 U.S. at 135).

Appellant has established that none of the income from its Exploration and Production functional department was derived from any activities in the State of Wisconsin. As all of Appellant's Exploration and Production activities occurred outside the State, Wisconsin's attempt to tax any of the income from these activities resulted in a Due Process violation as both the elements of a minimal connection (nexus) and a rational relationship were lacking. (See *Moorman, supra,* 437 U.S. at 272-273).

2. The Wisconsin Department of Revenue and the Wisconsin Supreme Court have both acknowledged that the exploration and production of oil and gas is "mining" within the meaning of the Wisconsin statutes, and that such activities are situs operations. Nevertheless, the Department and the Wisconsin Supreme Court, by making a distinction between realized income and unrealized income of the Exploration and Production Department, have attempted to circumvent the Wisconsin statutes. There were no Exploration and Production Department activities in the State of Wisconsin. Consequently, there was no connection or nexus nor any rational relationship between such activities and those carried on by Appellant in the State.

Wisconsin tried to satisfy these two requirements by making a distinction between situs income as part of the "unitary stream" and situs income that did not enter the "unitary stream." This was an attempt in semantics to make a distinction which is not constitutionally defensible. Situs income, *i.e.,* income having relationship only to the state of the source of such income, cannot be divided for purposes of non-situs state taxation into unitary situs income and non-unitary situs income in order to avoid these constitutional requirements. See *National Bellas Hess, Inc.* v. *Department of Revenue,* 386 U.S. 753 (1967).

Appellant in the record below, established that the total income derived from its Exploration and Production Department was derived outside of Wisconsin. Any inclusion of that income in the Wisconsin apportionment formula resulted in overreaching and the taxation of operations beyond the borders of Wisconsin. Separate functional accounting, upon which the identification of Appellant's Exploration and Production situs income was established, was clearly authorized and approved by this Court in *Moorman, supra.* Consistent with prior decisions of this Court, the ruling against Moorman was due to the lack of an appropriate record to establish the income from its Iowa activities and from its Illinois activities. The record in this case, however, contains the proof lacking in *Moorman* and in *Butler Brothers,* and confirms that the application of the Wisconsin statutes by the Wisconsin Supreme Court has rendered those statutes unconstitutional under the Due Process Clause of the Fourteenth Amendment to the United States Constitution.

3. Since 1920 there has been a series of cases which has held that all oil and gas production income was taxable in the producing states. *Shaffer* v. *Carter,* 252 U.S. 37 (1920); *Magnolia Petroleum Co.* v. *Oklahoma Tax Commission,* 190 Okla. 172, 121 P.2d 1008 (1942); *Texas Company* v. *Cooper,* 236 La. 380, 107 So.2d 676 (1959); and *Webb Resources* v. *McCoy,* 194 Kan. 758, 401 P.2d 879 (1965). As reflected by these cases, the jurisdictions where Appellant's Exploration and Production activities occurred had the power to impose an income tax on Appellant's Exploration and Production income. When Wisconsin also imposed a tax on this income, the result was multiple

taxation which constituted a burden on interstate commerce in violation of the Commerce Clause of the United States Constitution.

Both the Wisconsin Tax Appeals Commission (the trier of fact) and the Circuit Court on appeal found that the taxation of Appellant's Exploration and Production income by Wisconsin resulted in that income being subjected to multiple taxation. The multiple taxation doctrine makes it a violation of the Commerce Clause if a state, Wisconsin in this case, imposes a tax on the situs income derived from operations in another state, when that other state has the power to impose a tax on such operations, regardless of whether or not that power is exercised. This Court has confirmed that it is the *risk of* or the *potential burden of* multiple taxation that gives rise to a Commerce Clause violation and not just the actual fact of multiple taxation. See *e.g., J. D. Adams Mfg. Co.* v. *Storen,* 304 U.S. 307 (1938); *Standard Pressed Steel Co.* v. *Washington,* 419 U.S. 560 (1975). The Wisconsin Supreme Court, by allowing Wisconsin to tax Appellant's Exploration and Production activities, has condoned an application of the Wisconsin statutes that results in a violation of the multiple taxation doctrine and thereby violates the Commerce Clause of the United States Constitution.

ARGUMENT

I. The Wisconsin Supreme Court, By Finding That Appellant's Total Corporate Business Was Unitary As A Matter Of Law, Has Interpreted Wis. Stats. §71.07(2) In A Manner That Violates The Due Process Clause Of The Fourteenth Amendment To The United States Constitution.

Wis. Stats. § 71.07(2) reads, in part, as follows:

> "Persons engaged in business within and without the state shall be taxed only on such income as is derived from business transacted and property located within the state. The amount of such income attributable to Wisconsin may be determined by an allocation and separate accounting thereof, when the business of such person within the state is not an integral part of a unitary business. . . ."

In interpreting this particular statutory provision, the Wisconsin Supreme Court relied primarily on the decisions of this Court in *Hans Rees' Sons* v. *North Carolina,* 283 U.S. 123 (1931) and in *Butler Brothers* v. *McColgan,* 315 U.S. 501 (1942), two cases based on utterly different factual records and producing utterly different taxation results. The Wisconsin Supreme Court, however, asserted that both of these cases stood for the proposition that:

> ". . . the enterprise of a corporation which manufactures and sells its manufactured product is ordinarily a unitary business, and all the factors in that enterprise are essential to the realization of profits." (90 Wis.2d at 718, 281 N.W.2d at 104).

With this somewhat simplified view of the holdings in those two cases, and with the knowledge that only Appellant's Marketing Department engaged in activities in Wisconsin, the Wisconsin Supreme Court found, *as a matter of law,* that Appellant was a single corporate unitary business within the meaning of §71.07(2). This ignored and overruled the Commission's findings that Appellant's three principal operating departments, Exploration and Production, Refining and Marketing, were organized and operated as separate functional segments of Appellant's total corporate enterprise and were *each* unitary operations. (Findings of Fact Nos. 4 and 19; JS App. 67, 69). What the Wisconsin Supreme Court did was to make a determination that Appellant was engaged in the business of manufacturing and selling, and that it was, therefore, unitary *per se* and, hence, subject to having virtually its total corporate income included in the Wisconsin apportionment formula simply because of its very limited marketing activities in that State.

To support its unitary *per se* concept, the Wisconsin Supreme Court appears to have relied upon and did quote at length from an Oregon Tax Court decision which involved Appellant. *Humble Oil & Refining Co.* v. *Department of Revenue,* 4 OTR 284 (1971), is a decision with which Appellant disagrees, but, *more importantly and in any event,* the alleged "facts" and "conclusions" recited by the court in that case cannot be substituted for the record here, or for the findings of fact and conclusions of law by the Commission and by the Circuit Court in this case.

This unitary *per se* approach is certainly a novel one in state taxation, and does not pass constitutional muster under the Due Process Clause of the Fourteenth Amendment to the United States Constitution when compared

to all other decisions of this Court. Only four decisions of this Court have directly dealt with the "unitary" concept in connection with state taxation, and none of these decisions lends the slightest support to the Wisconsin Supreme Court's unique unitary *per se* concept.

In *Bass, Ratcliff & Gretton, Ltd.* v. *State Tax Commission,* 266 U.S. 271 (1924), this Court was presented with a challenge to the constitutional validity of a New York statute providing for an annual franchise or privilege of doing business tax in New York on foreign corporations. This tax was measured by the net income of the corporation, and the tax was determined by the proportion of the value of certain assets within the state compared to the total value of all such assets located everywhere. This Court found that Bass, Ratcliff was engaged in the unitary business of manufacturing and selling ale, that the practice of manufacturing resulted in no profits until there were sales, and that as such the State Tax Commission was justified in attributing to New York for taxation a just proportion of the profits earned by Bass, Ratcliff from the unitary business. This Court pointed out that it did not believe that the application of New York's statutory taxation method produced an unreasonable result, was inherently arbitrary, or was an attempt to reach profits earned elsewhere. It was stressed that there was no evidence in the record to determine if Bass, Ratcliff had received any net income from its New York business or to determine the amount of any profit or loss on that business when either considered separately or together with the manufacturing business done in Great Britain. Notably, the controlling factor was the factual record, or lack thereof, on where the income was earned, not any basic "unitary" concept.

In *Hans Rees' Sons* v. *North Carolina, supra,* this Court considered a challenge to the North Carolina income tax

as assessed against Hans Rees' pursuant to a single-factor (property) apportionment formula. Hans Rees' was a New York corporation engaged in the business of tanning, manufacturing and selling leather. The taxpayer had a manufacturing plant located in North Carolina. Its sales office was located in New York. Sales were made throughout the United States and abroad. Some sales were also made in North Carolina. Hans Rees' established that the income from its business was derived from three sources: (1) buying profit, (2) manufacturing profit, and (3) selling profit. The record also established that for the years in issue, the average income with its source in the manufacturing and tanning operations within North Carolina was 17 percent. The State of North Carolina had, pursuant to its statutory method, for the years in question assessed between 66 and 85 percent of Hans Rees' income to the State. This Court was of the opinion that, when a corporation manufactures in one state and sells in another, the net profits of the entire transaction, as a unitary business, could not be attributed, *in disregard of the evidence,* to either state. In elaborating on this position this Court stated:

> "Undoubtedly the enterprise of a corporation which manufactures and sells its manufactured product is ordinarily a unitary business, and all the factors in that enterprise are essential to the realization of profits. The difficulty of making an exact apportionment is apparent, and hence, when the state has adopted a method not intrinsically arbitrary, it will be sustained until proof is offered of an unreasonable and arbitrary application in particular cases. But *the fact that the corporate enterprise is a unitary one,* in the sense that the ultimate gain is derived from the entire business, *does not mean* that for the purpose of taxation *the activities which are conducted in different jurisdictions are to be regarded as 'component parts of*

> *a single unit' so that the entire income may be taxed in one state regardless of the extent to which it may be derived from the conduct of the enterprise in another state.* As was said in the Bass Case with regard to 'the unitary business of manufacturing and selling ale' which began with manufacturing in England and ended in sales in New York, that state 'was justified in attributing to New York a just proportion of the profits earned by the Company from such unitary business.' And the principle that was recognized in National Leather Company v. Massachusetts, supra, was that a tax could lawfully be imposed upon a foreign corporation with respect to 'the proportionate part of its total net income which is attributable to the business carried on within the State.' When, as in this case, there are different taxing jurisdictions, each competent to lay a tax with respect to what lies within, and is done within, its own borders, and the question is necessarily one of apportionment, evidence may always be received which tends to show that a state has applied a method, which, albeit fair on its face, *operates so as to reach profits which are in no just sense attributable to transactions within its jurisdiction.*" (283 U.S. at 133-34; Emphasis added).

From the above quote, it is obvious that this Court rejected a unitary *per se* concept, a concept that has not been approved in any subsequent decisions. Nor has *Hans Rees'* been overruled or modified by this Court; it still stands as controlling law in state taxation cases involving apportionment and allocation of income derived from multistate operations.

In *Butler Brothers* v. *McColgan, supra,* the taxpayer contested an assessment under the California Franchise Tax, which is assessed against a corporation's net income as attributed to the state by an apportionment formula. Butler Brothers was an Illinois corporation qualified to do

business in California with its home office in Chicago, Illinois, and it was engaged in the wholesale dry goods and general merchandise business, purchasing from manufacturers and selling to retailers. It maintained a wholesale distributing house in California and all receipts from sales in California were credited to the San Francisco house for the period in question by deducting from the gross sales receipts in California the cost of such merchandise, the direct expenses of the San Francisco house and the indirect expense allocated to it. This resulted in a loss. The California Tax Commissioner, utilizing an apportionment formula consisting of property, wages and sales, allocated 8.1 percent of Butler Brothers' total corporate net income to California. The taxpayer contended that by use of this formula California had converted a substantial loss into a profit, and that the difference had either been created out of nothing or had been apportioned by California from other states. This Court did not accept Butler Brothers' position. In finding that Butler Brothers was a unitary business, relying primarily on *Hans Rees'* and *Bass, Ratcliff,* and in affirming the tax imposed by California, this Court stated:

> "One who attacks a formula of apportionment carries a distinct burden of showing by 'clear and cogent evidence' that it results in extraterritorial values being taxed. See Norfolk & Western Ry. Co. v. North Carolina, 297 U.S. 682, 688, 56 S.Ct. 625, 628, 80 L.Ed. 977. This Court held in Hans Rees' Sons, Inc. v. North Carolina, supra, 283 U.S. page 135, 51 S.Ct. page 389, 75 L.Ed 879, that that burden had been maintained on a showing by the taxpayer that *'in any aspect of the evidence' its income attributable to North Carolina was 'out of all appropriate proportion to the business' transacted by the taxpayer in that State.* No such showing has been made here." (315 U.S. at 507; Emphasis added).

This Court went on to stress that Butler Brothers had *not* shown the precise sources of its net income, and had *not* shown any factors responsible for that income being earned in states other than California. It was also emphasized that no showing had been made that income unconnected with the unitary business had been included in the formula by California. Thus, like Bass, Ratcliff, Butler Brothers lost because of a failure of proper proof.

This Court's most recent opinion regarding state taxation of an interstate business by means of an apportionment formula was rendered in *Moorman Manufacturing Co.* v. *Bair*, 437 U.S. 267 (1978). Moorman, an Illinois corporation, was engaged in the manufacturing and sale of animals feeds. It sold products to Iowa customers through salesmen and from warehouses in that state. All of the product was manufactured in Illinois. The Iowa apportionment formula is a single-factor formula utilizing sales. Under the Iowa statute the income attributable to Iowa is determined by first eliminating income allocable to other states. From the remaining income, that attributable to business done in Iowa is calculated by applying to the remaining income a fraction obtained from taking that proportion of the gross sales made within the state to total gross sales. Moorman challenged the constitutionality of the Iowa single-factor formula, and the trial court held the formula invalid under the Due Process and Commerce Clauses of the United States Constitution. The Supreme Court of Iowa reversed, and the case then came before this Court. This Court, in responding to Moorman's contention that Iowa's single-factor formula resulted in the taxation of extraterritorial income in violation of the Due Process Clause, stated:

> "Appellant does not suggest that it has *shown* that a significant portion of the income attributed to Iowa in fact was generated by its Illinois operations; *the*

record does not contain any separate accounting analysis showing what portion of appellant's profits was attributable to sales, to manufacturing, or to any other phase of the company's operations.'' (437 U.S. at 272; Emphasis added).

Further on in its opinion this Court stated:

> ''The Iowa statute afforded appellant an opportunity to demonstrate that the single-factor formula produced an arbitrary result in its case. But *this record contains no such showing* and therefore the Director's assessment is not subject to challenge under the Due Process Clause.'' (Footnote omitted). (437 U.S. at 275; Emphasis added).

Thus, Moorman also failed for lack of a record showing the source of its income to be extraterritorial to the State of Iowa.

In the above quotations from *Moorman,* this Court, consistent with *Hans Rees'*, has set forth the framework necessary to establish a Due Process violation for a multistate business challenging a state's apportionment formula. *Moorman* thus acknowledges that separate functional accounting may be used by a taxpayer to identify the income or profits from the various phases or functions of the company's operations and thereby establish that the income attributed to a given state is ''out of all appropriate proportion to the business transacted . . . in that state.'' *Hans Rees' Sons, supra,* 283 U.S. at 135. It should be noted that the Wisconsin Supreme Court rejected this functional accounting approach by stating that it was merely *dicta,* thus ignoring this Court's prescription for testing a Due Process challenge to a state's method of apportionment. In the record, Moorman made *no* attempt to establish the profits or income of its manufacturing operation in Illinois; it only compared the results produced by Iowa's single-factor (sales) formula with those produced by the typical three-factor (sales, payroll and property) formula,

which was not ''evidence'' but a mere exercise in arithmetic. (See Iowa Supreme Court opinion, 254 N.W.2d 737, 750). Without a proper evidentiary record, this Court had no alternative but to find that Moorman had not shown that Iowa had taxed extraterritorial income.

In the present case Appellant has done exactly what this Court indicated Moorman should have done in order to establish the taxation of extraterritorial income. By separate functional accounting, Appellant has shown the net income for all three of its principal functional operations. In Schedule A to Exhibit 28 (A. 760) Appellant set forth its Wisconsin results for the years in issue computed by four different accounting methods:

(1) On a separate, geographical accounting basis;

(2) On a taxable income and tax basis if apportionment was used for its Marketing function alone;

(3) On a taxable income and tax basis if apportionment was used for its combined Marketing and Refining functions; and

(4) On a taxable income and tax basis if apportionment was used after the allocation of income from the Exploration and Production function to situs.

The fourth computation above shows that there is a spread of approximately 2.5 million dollars between the income taxable by Wisconsin if Exploration and Production income is allocated to situs and the income the State here attempts to pull in and tax under its apportionment method, or an increase of 76 per cent in alleged taxable income and an increase of 75.6 per cent in alleged taxes due.

In addition, the testimony of Appellant's witnesses established that Appellant's operational functions were conducted and were accounted for as separate segments of its

total enterprise (Findings of Fact No. 4, JS App. 67), and that the Exploration and Production Department income was all earned outside of Wisconsin from activities outside Wisconsin (Findings of Fact Nos. 11 and 18, JS App. 68, 69). The Department (of Revenue) offered no contrary evidence. By functional separate accounting, and also by separate accounting for Wisconsin operations, Appellant has proven that extraterritorial income from its Exploration and Production Department operations was included in the Wisconsin apportionment formula, thereby resulting in a Due Process Clause violation.

Moreover, the fact that Wisconsin's apportionment formula, as applied by the Department, attempts to tax income out of all appropriate proportion to the business transacted by Appellant in the State is conclusively demonstrated by Exhibit 29 (JS App. 87). This shows that Appellant earned a 3.2 percent average return on sales during the years in issue in its company-wide marketing operations, which included both the more profitable "mature areas" and the less profitable and unprofitable "expansion areas." All the testimony and the separate accounting, which the Department's witnesses acknowledged they could not refute (A. 627-635), indicated that Wisconsin was in the expansion marketing area classification and unprofitable.

The viability of the separate accounting was shown by testimony and Exhibit 27 (A. 758), which proved that the cost ingredients were separately determined for Wisconsin with only an administrative overhead calculation being allocated, and that, even by eliminating this allocation, no material taxable income was created (A. 365-368). Despite this, the Department's assessment attributes to Wisconsin marketing (Appellant's only Wisconsin activity), an average return for the years in issue equal to 7.5 percent of sales, which is approximately 2½ times the company-wide experience including the profitable mature areas for the same period.

What could better demonstrate factually that the Department's assessment is an overreach which subjected to Wisconsin taxation income out of all appropriate proportion to the business transacted by Appellant in the State? Thus, when considered with the unrefuted functional and Wisconsin separate accounting results, Appellant has succeeded under this Court's *Moorman* criteria in establishing an unconstitutional overreach. This Court's prescription in *Moorman,* which the Wisconsin Supreme Court chose to ignore, has been clearly filled to the requisite standard by Appellant's record in the present case.

Therefore, within the framework established by this Court in *Bass, Ratcliff, Hans Rees', Butler Brothers* and *Moorman,* the decision of the Wisconsin Supreme Court and its unitary *per se* concept cannot stand. None of these decisions has reached a finding of unitary *per se.* A finding of unitary at the very most provides merely a condition precedent to the right to apply an apportionment formula to the income of that so-called unitary business, providing that the taxpayer is unable to show either that all or part of that income is not subject to taxation as not being attributable to business done in the state, or that the resulting tax is out of all proportion to business conducted in the state. In *Bass, Ratcliff, Butler Brothers* and *Moorman* the taxpayer's proof was not sufficient to overcome the condition precedent. However, in *Hans Rees'* it was, and this Court struck down North Carolina's method of taxation as unconstitutional. With Appellant's record, the same result must occur here.

The opinion of the Wisconsin Supreme Court has even less constitutional validity when the facts in *Bass, Ratcliff, Hans Rees', Butler Brothers* and *Moorman* are compared

to those in the present case. *Bass, Ratcliff, Hans Rees'* and *Moorman* involved businesses engaged in manufacturing and selling, and *Butler Brothers* was a business engaged in purchasing and selling. None of these cases concerned a vertically integrated petroleum company operating under the principle of functional profitability independence, as is more specifically described in the Statement of the Case. Appellant's separate functional structure (Finding of Facts Nos. 4, 19, JS App. 67, 69), with its separate internal functional and Wisconsin accounting, makes the unitary *per se* concept expressed by the Wisconsin Supreme Court wholly indefensible.

This is further shown by testing the Wisconsin assessment against the two elements of Due Process, a minimal connection and a rational relationship (*Moorman, supra,* 437 U.S. at 272-273). Proper analysis should separate the "integral part of a unitary business" phrase in Wis. Stats. §71.07(2) into two parts. "Unitary" is a description of the business itself, while "integral part" is the relationship of Wisconsin activity to out-of-state activity. The latter directly invokes the "rational connection" element of Due Process, and this is one of the issues upon which this Court should focus.

Neither the Department nor the Wisconsin court has distinguished the two elements of the statutory phrase. In fact, the court utilized a test from *Interstate Finance Corp.* v. *Dept. of Taxation,* 28 Wis.2d 262, 269, 137 N.W.2d 38, 41-42 (1965), which in turn was taken from Altman & Keesling, *Allocation of Income In State Taxation* 101 (2d ed. 1950), which states that:

> ". . . the essential test is whether or not the operation of the portion of the business within the state is dependent upon or contributory to the operation of the business outside the state. If there is such a relationship the business is unitary."

While stated as the test for "unitary", this definition really focuses on the "integral part" portion of the statutory phrase, and indicates that either dependence *or* contribution will satisfy the test. It should be noted that the original author of this test subsequently changed his view to dependence *and* contribution. Keesling and Warren, *The Unitary Concept,* 12 Hastings L.J. 42, 46, 48 (Aug. 1960).

The Wisconsin court found Appellant to be unitary as a matter of law without any discussion of the integral part element, this despite trial court findings of fact as to *no economic dependence* between Appellant's Wisconsin marketing and its Exploration and Production or its Refining functions (Findings of Fact Nos. 21 and 23, JS App. 69), and as to *no integral relationship* existing between Wisconsin marketing and Appellant's Exploration and Production and its Refining functions (Findings of Fact Nos. 20 and 22, JS App. 69). Thus, the court in effect held that contribution *alone* is sufficient rational relationship for taxation. Also, it either assumed that Wisconsin marketing made a positive contribution to Appellant, contrary to the unrefuted evidence from separate accounting that Appellant incurred substantial losses in Wisconsin, or it held that even a negative contribution satisfies the test.

As part of the Due Process issues presented, this Court should address the constitutional appropriateness of utilizing mere contribution, particularly negative contribuiton, to establish the existence of a rational relationship, and thereby satisfy this Due Process requirement. It is submitted that mere contribution is not a constitutionally appropriate test, and that the proper test for the rational relationship element of Due Process should involve the question of whether the in-state activity is "necessary" to one or more of the taxpayer's out-of-state functional

operations; and if this finding is affirmative, then apportionment may be utilized as to *only* those functional operations of the taxpayer where this rational relationship exists. This standard would recognize that a corporate taxpayer may have more than one functional business within its corporate shell, and for a state to apportion total corporate income there must be a rational relationship between the state and *each* functional business. Otherwise, the state can only apportion corporate income from those functional segments where such a relationship exists.

II. The Assessment Of Wisconsin Tax On Income Derived From Appellant's Exploration And Production Functional Operations Outside The State From Extraction Of Oil And Gas Not Sold To Third Parties At The Well Head Constitutes A Construction Of Wis. Stats. §§71.07(1) and (2) Which Violates The Due Process Clause Of The Fourteenth Amendment To the United States Constitution.

The Wisconsin Supreme Court upheld the Department's interpretation of the situs income exclusion contained in Wis. Stats. §§71.07(1) and (2) "to apply only to income derived from sales to third parties at or near the well head." (90 Wis.2d at 705, 281 N.W.2d at 97.) By this ruling, the Wisconsin Court adopted the "barrel formula" applied by the Department in its audit of Appellant. This barrel formula was devised and utilized by the Department to reflect its belief that crude oil sold to third parties at the well head was situs income requiring allocation under the Wisconsin statutes, and that income derived from crude oil produced by Appellant and transferred to its Refining Department was not so allocable but rather was required to be included in apportionable income. This barrel formula was very complex in nature, was based on a variety of assumptions (A. 399-403; Exhibits 1 and 31, A. 601-627

and 791-798), was admitted to be the product of the imagination of an employee of the Department, and was not founded upon the Wisconsin statutes or upon any rules or regulations of the Department. (A. 74-75, 80 and 121-122). In addition, the separation attempted by the Department was an impossible one, for Appellant both bought and sold crude oil and the crude oil that went to its Refining Department completely lost its identity due to commingling of produced crude and purchased crude.

The Department's "barrel formula" does not find support in the only statutory reference to situs income contained in §§71.07(1) and (2). The relevant provisions of §71.07(1) read as follows:

> "For the purposes of taxation income or loss from business, not requiring apportionment under sub. (2), (3) or (5), shall follow the situs of the business from which derived. Income or loss *derived* from rentals and royalties from real estate or tangible personal property, or from the operation of any farm, *mine* or quarry, or from the sale of real property or tangible personal property *shall follow the situs of the property from which derived.*" (Emphasis added).

Section 71.07(2) provides, in pertinent part, as follows:

> "In all cases in which allocation and separate accounting is not permissible, the determination shall be made in the following manner: . . . there shall first be deducted from the total net income of the taxpayer such part thereof (less related expenses, if any) as follows the situs of the property or the residence of the recipient. . . ."

The Department and the Wisconsin Supreme Court have acknowledged that the exploration and production of oil and gas is "mining" within the meaning of Wis. Stats. §71.07(1), and that such activities are situs operations (see JS App. 21). The Department by means of the "barrel formula", and the Wisconsin Supreme Court by approving

the same, have attempted to circumvent the mandate of the Wisconsin statutes, which requires all income "derived" from oil and gas exploration and production to be allocated to situs, and which thereby eliminates such situs income from apportionable income.

In the trial record Appellant established that, pursuant to its accounting practices and those of the industry, all of the income of its Exploration and Production Department was calculated from actual market place sales of crude oil to third parties at the posted field price or from internal transfers between Appellant's Exploration and Production Department and its Refining Department which transfers were based upon the posted field prices utilized in the industry. The record also established that the posted field prices were bona fide market prices. Therefore, all internal transfers of crude oil by Appellant were made at the posted field price for the particular grade and field from which the crude was produced, as if that crude had been sold to a third party in the open market place. Furthermore, the record established that the crude oil which went to Appellant's Refining Department was produced completely outside of Wisconsin. Appellant's total Exploration and Production functional income, therefore, was derived at the situs of the exploration and production activities and, under the Wisconsin statutes, was required to be so allocated and not apportioned, as all such activities occurred outside of Wisconsin. Schedule A of Exhibit 28 (see Appendix I, JS App. 86) sets forth the taxable income and tax attributable to Wisconsin with Exploration and Production functional income allocated to situs, and shows a difference in favor of the State in taxable income from the State audit of $2,574,526 and a resulting difference in tax from that audit of $180,217. Such additional tax imposed by the State was simply the result of an unconstitutional overreach.

This Court, in *Northwestern States Portland Cement Co.* v. *Minnesota,* 358 U.S. 450 (1959), held that the net income of the interstate operations of a foreign corporation may be subjected to state taxation provided the tax is not discriminatory and is properly apportioned to activities within the taxing state forming sufficient nexus to support the tax. And it seems clear from *National Bellas Hess, Inc.* v. *Department of Revenue,* 386 U.S. 753 (1967), that a state may not impose a tax unless there is some minimum connection between the particular activities of the taxpayer in the taxing state with identical or similar activities of the taxpayer outside the taxing state.

It should be noted at this point that Appellant is not raising the question of the right of the State of Wisconsin to tax income derived *in* that State from the operations of a multistate business, nor the validity of Wisconsin's three-factor formula *when properly applied.* However, in subjecting virtually all of Appellant's Exploration and Production functional income to apportionment by Wisconsin, the Wisconsin Supreme Court has ignored the nexus requirement of *National Bellas Hess* and *Northwestern States.* There were no Exploration and Production functional activities in Wisconsin, so there could be no connection between such activities and the State. Wisconsin tries to satisfy the nexus requirement by making a distinction between situs income as part of the "unitary stream" and situs income that does not enter the "unitary stream." This is clearly an attempt in semantics to make a distinction which is not constitutionally defensible. Situs income, *i.e.,* income having relationship only to the state of the source of such income, cannot be divided for purposes of non-situs state taxation into unitary situs income and non-unitary situs income in order to avoid the constitutional nexus requirement.

Appellant is aware of no decision of this Court involving application of an apportionment formula to operational situs income earned outside the taxing state. However, this Court has dealt with a somewhat parallel problem involving the assessment of *ad valorem* property taxes against multistate businesses. In *Norfolk and Western Railway Co.* v. *Missouri State Tax Commission,* 390 U.S. 317 (1968), the taxpayer challenged Missouri's *ad valorem* property tax assessed against its total value of railroad rolling stock based upon a mileage formula calculated as the ratio of the total number of miles of road in Missouri to the total miles of the road owned by the taxpayer everywhere. The taxpayer submitted evidence showing that the actual value of all its rolling stock in the state on the tax day was actually about 38% of the figure calculated by the state through its formula. The taxpayer also submitted evidence showing that the tax day inventory was a normal daily inventory of its rolling stock in the state. This Court found that the tax as applied by Missouri was invalid as casting that State's tax burden upon property located beyond the borders of the State. This Court indicated that the taxpayer had satisfied the burden of proving that the application of the mileage formula had resulted in gross overreaching beyond the values represented by the intrastate assets purported to be taxed and thereby had violated the Due Process and Commerce Clauses of the United States Constitution, by stating:

> "*A State will not be permitted,* under the shelter of an imprecise allocation formula or by ignoring the peculiarities of a given enterprise, *to 'project the taxing power of the state plainly beyond its borders.'* Nashville, C. & St. L.R.Co. v. Browning, 310 U.S. 362, 365, 60 S.Ct. 968, 970, 84 L.Ed. 1254 (1940). Any formula used must bear a *rational relationship,* both on its face and in its application, to property values connected with the taxing State. Fargo v. Hart, 193 U.S. 490, 499-500, 24 S.Ct. 498, 500, 48 L.Ed. 761 (1904)." (Footnote omitted). (390 U.S. at 325; Emphasis added).

Just as the taxpayer in *Norfolk* showed the actual value of property in the state to establish an overreaching in taxation of property located outside of Missouri, Appellant here has established the total value of the income derived from its Exploration and Production Department, all outside of Wisconsin, and has established that the inclusion of any of that income in Wisconsin's apportionment formula (resulting in additional income apportioned to Wisconsin of $2,574,526) results in overreaching and taxation of operations beyond the borders of the State of Wisconsin.

In addition, the general prohibitions set forth in *Hans Rees', supra,* are also controlling to prevent the taxation of Appellant's Exploration and Production situs income, as this would otherwise result in unreasonably and arbitrarily attributing to Wisconsin "a percentage of income out of all appropriate proportion to the business transacted by the appellant in that state." (283 U.S. at 135). This clearly violates the rational relationship Due Process requirement.

It further should be emphasized that separate functional accounting, upon which the identification of Appellant's Exploration and Production situs income is established, was clearly authorized and approved by this Court in *Moorman:*

> "Appellant does not suggest that it has shown that a significant portion of the income attributed to Iowa in fact was generated by its Illinois operations; the record does not contain any separate accounting analysis showing what portion of appellant's profits were attributable to sales, to manufacturing, or to any other phase of the company's operations." (437 U.S. at 272).

Such prescribed functional accounting is clearly present in the record here. In addition, separate accounting for Wisconsin operations is available to corroborate the obvious conclusion that extraterritorial income is being taxed by the State of Wisconsin. See Part I of this brief, *supra*, and particularly Schedule A to Exhibit 28 (A. 760; JS App. 86).

The Wisconsin Supreme Court asserted that the above language from the *Moorman* decision was merely *dicta* and that the idea of separate functional accounting seemed to be incompatible with the concept of formula apportionment. In this regard it cited as the only authority, Hellerstein, *State and Local Taxation* (3d ed. 1969) (see JS App. 24). Clearly, this Court's recent language in *Moorman* expresses the Court's acknowledgement that separate functional accounting can be an accurate means of determining whether or not there has been a Due Process violation in apportionment formula situations, so Hellerstein's ten year old treatise cannot be cited as an authority in the context of this case.

The quote from Hellerstein relied on by the Wisconsin Supreme Court, to disregard Appellant's functional accounting record, reflects the observation, expressed in numerous decisions of this Court and of lower courts, that there is great difficulty in separating out the manufacturing profit from the selling profit of a multistate business that manufactures in one or more states and then sells in one or more other states. Thus, an apportionment formula, which is designed to assign to a given state that portion of net income reasonably attributable to business done in that state, will be preferred to some type of geographical separate accounting. *Underwood Typewriter Co.* v. *Chamberlain*, 254 U.S. 113 (1920); *Bass, Ratcliff, supra; Hans Rees', supra; Butler Brothers, supra; Northwestern States, supra;* and *Moorman, supra.*

Without exception, all of the cases adopting the above reasoning have involved taxpayers engaged in manufacturing or purchasing and then selling. And, until *Moorman*, one of the basic principles emerging from these cases was the recognition of the apparent impossibility to identify the precise sources of net income derived from a multistate business engaged in manufacturing and selling. Therefore, states were given considerable leeway in adopting apportionment formulas to tax the income of such multistate businesses. *International Harvester Co.* v. *Evatt*, 329 U.S. 416 (1947). But due to the organizational structure and operation of Appellant, with its separate functional operating departments and the sophistication of its accounting procedures, the reasoning of these earlier decisions is not applicable in the present case. In sharp contrast, Appellant's Exploration and Production function is not part of and is completely different from a manufacturing and sales business. Oil and gas exploration and production involves the finding and extraction of minerals in place, minerals that are assets uniquely associated with a particular state, the state of production.

This Court further acknowledges the validity of functional accounting by its statement in *Moorman* that:

> "The Iowa statute afforded appellant an opportunity to demonstrate that the single-factor formula produced an arbitrary result in its case. But this record contains no such showing and therefore the Director's assessment is not subject to challenge under the Due Process Clause." (437 U.S. at 275).

In footnote no. 9 at the end of the above paragraph, this Court refers to the concurring opinion of Justice McCormick of the Iowa Supreme Court, and sets forth in this footnote the following quote from that opinion:

> "In the present case, Moorman did not attempt to prove the amount of its actual net income from Iowa

> activities in the years involved. Therefore no basis was presented for comparison of the corporation's Iowa income and the income apportioned to Iowa under the formula. *In this era of sophisticated accounting techniques, it should not be impossible for a unitary corporation to prove its actual income from activities in a particular state.*" (437 U.S. at 275; Emphasis added).

Consequently, this Court has now recognized that a taxpayer's accounting procedures may be sufficient to establish a Due Process violation.

Appellant's separate functional accounting, as set forth in the record before the Commission, isolated and identified all of the income derived and fully earned at the situs of production for the Exploration and Production Department. In all instances these locations were in states other than Wisconsin.

The record in this case, therefore, contains the proof lacking in *Moorman,* in *Butler Brothers* and in *Bass, Ratcliff*. That proof is confirmed by the following three Findings of Fact by the Commission (see Appendix C at JS App. 67-69) which were not challenged by the Department at either the Circuit Court or the Supreme Court of Wisconsin level:

> "4. The petitioner's three principal operating departments, exploration and production, refining, and marketing, were organized and operated as separate segments and separate functional operations of the petitioner's total corporate enterprise."
>
> "10. The petitioner utilized internal transfer prices between its functional departments that were the equivalent of third-party competitive prices."
>
> "18. During the period involved herein, income derived from each of the petitioner's functional operating departments could be determined from the petitioner's books and records."

The Wisconsin Supreme Court, in an attempt to discount the record made by Appellant, has made a distinction between "realized" income, *i.e.,* that resulting from sales to third parties, which it concludes is situs income outside of the unitary stream, and "derived" income, *i.e.,* transferred internally at posted field prices, which it considers to be within the unitary stream, despite the fact that the Wisconsin statute, §§71.07(1) and (2), uses only the term "derived" to apply to both situations. Thus, the Wisconsin Supreme Court has written into the statute a distinction which does not exist in the statutory language.

Certainly no such distinction has ever been made by this Court. Indeed, this Court has never recognized that only "realized" income can be used for determining taxable income. On the contrary, this Court has used such words as "attributable to" (*Hans Rees'*), "derived" (*Butler Brothers*) and "earned" (*Moorman*) to describe taxable income. In short, the Wisconsin Supreme Court cannot, upon the pretext of dividing situs income between unitary and non-unitary or between realized and derived, attempt to avoid the constitutional prohibitions against taxing income that has no rational relationship to the taxing state. A repeat of a quote already set forth in Part I of this brief, *supra,* is most appropriate to the present situation:

> "But the fact that the corporate enterprise is a unitary one, in the sense that the ultimate gain is derived from the entire business, does not mean that for the purposes of taxation the activities which are conducted in different jurisdictions are to be regarded as 'component parts of a single unit' so that the entire net income may be taxed in one state regardless of the extent in which it may be derived from the conduct of the enterprise in another state." (*Hans Rees', supra,* 283 U.S. at 133).

At this point, it is interesting to note that the Wisconsin Supreme Court by making a distinction between realized income and derived income has in effect, without so acknowledging, overruled two of its earlier decisions. In *Standard Oil Co.* v. *Wisconsin Tax Commission,* 197 Wis. 630, 223 N.W. 85 (1929), the Wisconsin Supreme Court was presented with the position by the State that:

> "A person realizes a profit or loss on the sale of product when such product is disposed of. To anticipate departmental profits in advance of sale of the product by taking a manufacturing profit, a transportation profit, or a selling profit at different stages and times, is arbitrary." (197 Wis. at 636, 223 N.W. at 88).

The response by the Wisconsin Supreme Court to the contrary was sharp and clear:

> "Nor do we find anything in *Underwood Typewriter Co.* v. *Chamberlain,* 254 U.S. 113, 41 Sup.Ct. 45, inconsistent with our conclusion in this case. There, there was no separation on the basis of market value between the operations of the manufacturing department and the sales department as there is in this case. We perceive no reason why, under the facts in this case, the profits *derived* from the sales operations should not be ascertained, so far as plaintiff is concerned, as they would be if the sales operations were conducted by a separate corporate entity. In either case the profits are *earned* at the same time and place. (197 Wis. at 639, 223 N.W. at 88-89; Emphasis added).

In *Kansas City Star Co.* v. *Wisconsin Department of Taxation,* 8 Wis.2d 441, 99 N.W.2d 718 (1959), the Wisconsin Supreme Court upheld the right of a taxpayer to utilize intra-company transfer prices, which were based on prices used in the industry in third-party transactions, for purposes of determining the corporation's divisional income in Wisconsin. The reasoning in the *Kansas City Star* and *Standard Oil* cases is sound and highlights the Due Process

violation resulting from the Wisconsin Supreme Court's decision in the present case.

This Due Process violation is brought about by the Wisconsin Supreme Court holding that income derived from Appellant's Exploration and Production functional operations outside of Wisconsin, consisting of the extraction of oil and gas not sold to third parties at the well head, was required to be included in apportionable income. Such a violation is confirmed by decisions from other jurisdictions.

The Minnesota Supreme Court in *Skelly Oil Company* v. *Commissioner of Taxation,* 269 Minn. 351, 131 N.W.2d 632 (1964), concluded that the exploration and production, refining and marketing functions of Skelly were operated as separate businesses. Further, it was concluded that because posted field prices were competitively established, were employed for federal depletion, severance tax, production states' income tax and royalty payment purposes, and were utilized as the prices for which the taxpayer bought and sold crude oil, they constituted a bona fide base for internal transfer pricing from production to refining. Adding this all together, the Minnesota Supreme Court held that only marketing income was exposed to taxation as this was the only function being carried on in Minnesota, and that the unitary concept was inapplicable. The Minnesota Supreme Court distinguished *Butler Brothers, supra,* with the following observation that is equally applicable to this case:

> "As was emphasized in the *Butler Brothers* case, a state may tax only income 'created by business within its borders.' Clearly, the fact that Skelly's production income is fully earned at the point where the crude oil is produced and is neither more nor less than what it would be if Skelly had no refineries, distinguishes the situation here from that case. (269 Minn. at 373, 131 N.W.2d at 646).

That court then concluded:

> "Skelly's sole activity in Minnesota is the marketing of finished products, as the proof clearly shows. The only permissible conclusion is that taxes based on the inclusion of production income, no matter what the percentage, in apportionable income are beyond the state's authority. Minnesota may include in the apportionable income subject to its tax only income attributable to Skelly's marketing activity." (269 Minn. at 373, 131 N.W.2d at 646).

In *Tenneco, Inc.* v. *Barr,* 224 So.2d 208 (Miss. 1969), the taxpayer operated a gas transmission system, part of which was situated in Mississippi and a gas exploration and production function carried on outside Mississippi. The former operated at a profit and the latter at a loss. The taxpayer sought total apportionment on the unitary theory. The Mississippi Supreme Court held the transmission business alone to be unitary and subject to apportionment, but found that the gas exploration and production operations were not unitary with or an integral part of the transmission operations, and hence, separate accounting applied to those functions.

The Circuit Court of Appeals of the Eighth Circuit, in *Standard Oil Co.* v. *Thoresen,* 29 F.2d 708 (8th Cir. 1928), held that under the law of North Dakota the plaintiff oil company was not required to pay North Dakota taxes on its producing and refining oil business done only in other states simply because it engaged in the business of marketing refined products in North Dakota. The Eighth Circuit was of the opinion that any statute of a state which attempted to tax income from property located in another state was void as being beyond the power of the taxing state.

Furthermore, the supreme courts of three oil and gas producing states have addressed this issue, and have held

that the income from oil and gas production was allocable to situs and taxable in each respective producing state, regardless of whether or not the taxpayer corporation was unitary or whether the income was actually realized or was derived from a fair market value computation. *Magnolia Petroleum Co.* v. *Oklahoma Tax Commission,* 190 Okla. 172, 121 P.2d 1008 (1942); *Texas Company* v. *Cooper,* 236 La. 380, 107 So.2d 676 (1959); *Webb Resources* v. *McCoy,* 194 Kan. 758, 401 P.2d 879 (1965).

Therefore, by creating two categories of situs income out of Appellant's Exploration and Production functional income, one being taxable and one not, the Wisconsin Supreme Court has rendered §§71.07(1) and (2) unconstitutional under the Due Process Clause of the Fourteenth Amendment to the United States Constitution.

In addition, the Wisconsin Supreme Court's Due Process analysis is further substantially deficient. The court said Appellant's activities had a "substantial nexus" with the state based solely upon sales volume by *its* Marketing Department (only) during the years in issue (90 Wis.2d at 729, 281 N.W.2d at 110; JS App. 29). This superficial analysis ignores the fundamental principles embodied in the Due Process Clause, namely, that the concept requires that there be some minimal connection between the activities taxed and the taxing state, and that the income attributable to the state for tax purposes be rationally related to values connected with the state. *Moorman, supra,* 437 U.S. at 272-273. The Wisconsin court's reasoning, that situs income can be taxed because it enters the "unitary stream", overlooked the rational relationship principle because it pulled in for Wisconsin taxation situs activities unrelated to Wisconsin and thereby subjected to taxation income out of all appropriate proportion to Appellant's Wisconsin activities.

The Wisconsin Supreme Court also supported the Department's assertion that it was entitled to its "fair share" of Appellant's income, and made reference to the fact that Wisconsin sales for the four years in issue represented .41 percent of Appellant's total sales and that Wisconsin assessed taxable income for these same years represented .22 percent of Appellant's total company income adjusted to a Wisconsin basis. Thus, the court appears to have applied a *de minimus* test to justify the taxation of a "fair share" of Appellant's income. In other words, since the assessed taxable income is so small compared to total company income, the resulting tax is conclusively presumed to be valid. There is no authority to support this position, for such "fair share" percentages cannot be invoked to obscure the 76 per cent increase in taxable income and the 75.6 per cent increase in taxes upheld by the Wisconsin Court's unitary *per se* concept (see above at p. 25). The tax imposed by Wisconsin must still pass *all* the constitutional tests imposed by the decisions of this Court regardless of the amount of taxable income apportioned to the taxing state. See *Northwestern States, supra; National Bellas Hess, supra; Hans Rees', supra;* and *Moorman, supra.*

Thus, this "fair share" approach ignores the essential Due Process concept of rational relationship; and the attempted employment of a "unitary stream" theory, while creative, cannot serve to bootstrap income with an undeniable situs in other states into Wisconsin for taxation purposes. The constitutional principles are not that elastic, and the essential rational relationship to tax Appellant's Exploration and Production functional income is missing here.

III. The Assessment Of Wisconsin Tax On Income Derived From Appellant's Exploration And Production Functional Operations Outside The State From Extraction Of Oil And Gas Not Sold To Third Parties At The Well Head Constitutes A Construction Of Wis. Stats. §§71.07(1) And (2) Which Violates The Commerce Clause Of Article One Of The United States Constitution.

Since 1920 there has been a series of cases which has held that all oil and gas production income was taxable in the producing states. *Shaffer* v. *Carter,* 252 U.S. 37 (1920); *Magnolia Petroleum, supra; Texas Company, supra; Webb Resources, supra.* As reflected by these cases, the jurisdictions where Appellant's exploration and production activities occurred have the power to impose an income tax on Appellant's Exploration and Production net income. Where other states such as Wisconsin also imposed a tax, this resulted in multiple taxation of that income and constituted a burden on interstate commerce in violation of the Commerce Clause of the United States Constitution.

The Commission found, based upon the testimony of various witnesses, that the taxation of Appellant's Exploration and Production income by Wisconsin resulted in that income being subjected to multiple taxation (see Appendix C, JS App. 71, Finding of Fact no. 33). On appeal the Circuit Court sustained this finding (see Appendix B, JS App. 41). The Wisconsin Supreme Court neatly sidestepped this finding by ignoring the foregoing income tax cases and observing, but without citing any authority, that the taxes imposed by the situs states might be imposed on production rather than on income, thus, in its view, eliminating any question as to multiple taxation or burden on interstate commerce. The precise language is:

> "The fact that the producing states may impose production taxes which are a form of property tax or severance taxes which have been held to be occupation taxes or property taxes does not render unfair or unconstitutional Wisconsin's efforts to reach a proportionate share of the taxpayer's income." (Footnotes omitted) (90 Wis.2d at 731, 281 N.W.2d at 110-11).

The compelled inferences from the foregoing are that multiple taxation as a burden on interstate commerce in violation of the Commerce Clause of the United States Constitution occurs only (a) if a situs state having the power to tax situs operations actually exercises that power, and (b) if the situs state does exercise its taxing power, the type of tax imposed must be of the same type as that imposed by the non-situs, apportioning state. This utterly ignores the basic propositions that a violation of the Commerce Clause occurs if a state, Wisconsin in this case, imposes a tax on the situs income derived from operations in another state if that other state has the *power* to impose a tax on such operations, regardless of whether or not that power is exercised.

This Court has, in a series of decisions, confirmed that it is the *risk* of or the *potential burden* of multiple taxation that gives rise to a Commerce Clause violation and not just the fact of multiple taxation. *J.D. Adams Mfg. Co.* v. *Storen,* 304 U.S. 307 (1938); *Gwin, White & Prince, Inc.* v. *Henneford,* 305 U.S. 434 (1939); *McLeod* v. *J.E. Dilworth Co.,* 322 U.S. 349 (1944); *Freeman* v. *Hewit,* 329 U.S. 249 (1946); *Central Railroad Co.* v. *Pennsylvania,* 370 U.S. 607 (1962); *General Motors Corporation* v. *Washington,* 377 U.S. 436 (1964); *Evco* v. *Jones,* 409 U.S. 91 (1972); *Standard Pressed Steel Co.* v. *Washington,* 419 U.S. 560 (1975); *Austin* v. *New Hampshire,* 420 U.S. 656 (1975). Thus, this principle is well documented in the decisions of this Court. In *McLeod* v. *Dilworth Co., supra,* the multiple taxation doctrine was defined:

> ". . . the state may not impose certain taxes on interstate commerce . . . because other states also may have the right constitutionally, apart from the commerce clause, to tax the same thing and either the actuality or the *risk* of their doing so makes the total burden cumulative. . . ." (322 U.S. at 358; Emphasis added).

As recently as 1975 this Court reaffirmed this doctrine. In *Standard Pressed Steel Co.* v. *Washington, supra,* this Court quoted from its opinion in *Gwin, White & Prince, Inc.* v. *Henneford, supra,* as follows:

> " '. . . The present tax, though nominally local, thus in its practical operation discriminates against interstate commerce, since it imposes upon it, merely because interstate commerce is being done, the *risk* of a multiple burden to which local commerce is not exposed.' " (419 U.S. at 564; Emphasis added).

Also in 1975, this Court made clear that the multiple taxation doctrine applies to preclude taxation by a state of income properly taxable by another state, whether or not the other state is currently exercising that power. In *Austin* v. *New Hampshire, supra,* this Court struck down New Hampshire's taxation of Maine residents who worked in New Hampshire, stating:

> "Nor . . . can the constitutionality of one State's statutes affecting nonresidents depend upon the present configuration of the statutes of another State." (420 U.S. at 668).

This principle was carefully explained by Mr. Justice Frankfurter in *Freeman* v. *Hewit, supra,* stating:

> ". . . But that, for the time being, only one State has taxed is irrelevant to the kind of freedom of trade which the Commerce Clause generated. The immunities implicit in the Commerce Clause and the potential taxing power of a State can hardly be made to depend, in the world of practical affairs, on the shifting incidence of the varying tax laws of the various States at a particular moment." (329 U.S. at 256).

Thus, it clearly is the *power* to tax the income in issue, not the actuality of taxation which controls. Here there can be no question that situs states, where Appellant's Exploration and Production functional activities were conducted, have the right to tax the net income derived therefrom; and for other states, such as Wisconsin, to also impose a tax on such income invokes the multiple taxation doctrine. Furthermore, contrary to the implication of the Wisconsin court's decision, the labels and phraseology employed by other taxing states are irrelevant, for this Court has emphasized that economic realities, not labels and phraseology, determine whether or not a tax on interstate activities is constitutional. *Complete Auto Transit, Inc.* v. *Brady,* 430 U.S. 274 (1977).

In the *Moorman* decision, *supra,* this Court dealt summarily with the taxpayer's multiple taxation argument, concluding that there was a failure of proof. We do not understand that this decision in any way altered the established multiple taxation doctrine, but it does indicate that a certain threshold of proof is necessary to invoke the doctrine. In *Moorman* that proof was lacking, so it could not be determined where the income was earned in order to establish the risk of multiple taxation. *Moorman* did not deal with a situs income situation. In the present case not only is situs income the issue, but the record specifies the amount of non-Wisconsin situs income Wisconsin has attempted to tax (see Appendix I, JS App. 86). Thus, the factual proof is clearly present to show the risk and thereby invoke the multiple taxation doctrine to invalidate under the Commerce Clause the Department's application of Wis. Stats. §71.07 to Appellant's Exploration and Production functional income.

Clearly, by any test, the Wisconsin Supreme Court in this case chose to ignore the true strictures of multiple taxation as a burden on interstate commerce. This erroneous conclusion of the Wisconsin Supreme Court is further underscored, both in terms of a violation of the Commerce Clause as well as of the Due Process Clause, by its conclusion that Wisconsin is entitled to tax its "fair share" of the total corporate income of a multistate corporation regardless of the relevancy of the taxation results to the activities carried on by the multistate corporation within the State of Wisconsin.

That this is an erroneous proposition should be patently obvious. The relevant statute itself, Wis. Stats. §71.07(2), restricts Wisconsin taxation to "only on such income as is derived from business transacted and property located within the state." Thus, the incidence of taxation must be related to Appellant's activities and property in the state. The record shows little property, no exploration and production or refining, and only some expansion marketing activity in Wisconsin during the years in issue. Thus, to consider total corporate income, regardless of the type of activity and regardless of where earned, is to employ a basically incorrect concept. The Commerce and Due Process Clauses both preclude a state from taxing activities which clearly have a situs in other states. There can be no "fair share" of something a state cannot constitutionally tax.

Therefore, in utilizing a unitary *per se* approach which subjects to apportionment virtually all of Appellant's total corporate income without regard to any relationship of the activities of Appellant to Wisconsin, the Wisconsin Supreme Court sanctioned multiple taxation as an obvious and automatic end result of such a concept, and thereby placed a burden on interstate commerce in violation of the Commerce Clause of the United States Constitution. That Appellant is disadvantaged when compared to Wisconsin intrastate operations should be obvious in that Appellant bears the risk of multiple taxation of its income.

CONCLUSION

Based upon the foregoing, it is clear that this case presents the requisite factual elements to fulfill the *Hans Rees'* and the *Moorman* prescriptions for determinations of Due Process and Commerce Clause violations. The constitutional analysis of the Wisconsin Supreme Court, by its unitary *per se* approach, is totally inconsistent with both current and historical constitutional jurisprudence. It is respectfully suggested that this Court should determine, based on the record in this case, the proper application of the Due Process Clause minimal connection (nexus) and rational relationship requirements and of the Commerce Clause multiple taxation doctrine.

Such a determination must result in this Court striking down the construction and application of the Wisconsin statutes by the Wisconsin Supreme Court as being repugnant to the Due Process and Commerce Clauses of the United States Constitution. In the process, this will also permit this Court to eliminate the split in authority existing between the present Wisconsin decision and the decisions of all other jurisdictions, state and federal, as set forth in this brief, which are wholly consistent with Appellant's position herein as regards taxation of situs operations.

It is, therefore, respectfully requested that the application of the Wisconsin statutes as construed by the Wisconsin Supreme Court be held unconstitutional, and that the decision of the Wisconsin Supreme Court be reversed, with directions that Appellant's Exploration and Production Department functional income be allocated to situs and excluded from Wisconsin apportionable income.

Respectfully submitted,

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